Testimony of Carl Wood
to the Michigan Senate Energy and Technology Committee

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Mr. Chairman and Senators:

My name is Carl Wood. I am the National Director for Regulatory Affairs for the Utility Workers Union of America (UWUA). My union represents thousands of employees at Consumers Energy, Detroit Edison and other utilities in Michigan. We are vitally concerned with the direction that you establish for the energy policy of the State of Michigan.

I served as a member of the California Public Utilities Commission from June 1999 through December 2004, encompassing the period of the California Energy Crisis and the beginning of the state's efforts to recover from it. During that time I also served as the Chair of the Consumer Affairs Committee of the National Association of Regulatory Utility Commissioners (NARUC).

The perspective I want to bring to you today is based on the idea that electricity is an essential service in modern life, and the facilities that are used to produce and deliver it are *infrastructure.* Our nation is facing severe economic challenges, Michigan no less than the rest of the country. As you marshal your resources to confront those challenges, attending to the long-term viability of that electricity infrastructure will be important – too important to leave entirely to the market or to private decision-making unresponsive to the larger public interest.

Michigan is experiencing challenges in the provision of its electric service that resemble California's in certain ways. Like California, Michigan partially deregulated its electric service. In the name of promoting retail so-called "consumer choice," our state disaggregated the systems for managing electric supply, incenting our investor-owned utilities (IOUs) to sell generation facilities and cede control of their transmission facilities, and trusting to the market to ensure the construction of new generation capacity. This has resulted in the utilities and their customers

being placed in a dependent net short position – that is, without sufficient owned or controlled generation to meet their normal load – forcing them to rely heavily for supply on the organized wholesale market regulated by the Federal Energy Regulatory Commission (FERC.)

Like California, Michigan's residential and business electricity users are now faced with rising rates and lagging investment in electric generation facilities. The so-called "organized" wholesale market – organized, that is, to maximize the market power of organized sellers to extract revenues from dependent buyers, your constituents – that market is inflicting damage on the economy of your state, indeed on the entire Midwest region.

Pursuing an approach to energy that is part of a comprehensive state plan to revitalize and re-invigorate Michigan's economy requires moving away from reliance on the wholesale energy markets, in favor of a long-range investment strategy that contributes to job creation and job retention in Michigan.

State-level policy makers and the entities they control – regulated utilities – represent the buyer side of the wholesale market. They should act like responsible providers to and agents for their constituents – retail end-use electric customers, both residents and businesses. Empowering electric utilities to serve load by giving them all of the tools they need to be effective suppliers – including authority, credit and access to capital for direct investment supported by retail rate revenues, as well as access to information about wholesale price formation – is responsible public policy. Such structural measures include:

- Revitalizing the obligation of retail providers to serve, including the obligation to plan and to invest, while limiting so-called "customer choice," or "retail competition."
- Retaining and expanding cost-based regulation for utility-owned generation in vertically-integrated structures.
- Establishing a sophisticated long-range planning process that informs construction of a dedicated supply portfolio and aggressive conservation investment.
- Establishing a state agency vehicle for direct investment in energy infrastructure as both a lowest cost approach and bench-mark competition for incumbent utilities.
- Reducing the energy cost burden of the most vulnerable consumers with ratepayer funded low-income discount and weatherization programs.

Today, California is a cautionary tale. Despite our famous energy woes, California has not broken with deregulation. Many of the same people that brought on the fiasco a dozen years ago are still in power. The Public Utilities Commission still faces pressure to restore direct access (as "customer choice" is called in the Golden State), led by major retailers such as Wal-Mart as well as the usual suspects: the profiteering marketers and independent generators. The electric rates charged by California investor-owned utilities are higher today than they were at the height of the Energy Crisis, despite years of effort by me and some of my colleagues. California, like Michigan, has still not decisively abjured courting the instability that discourages investment and sustains shortages that in turn drive up prices.

California has developed an uncoordinated approach to electric supply that emphasizes incentives at the expense of affordability, arbitrarily limits electricity supply options, and at the same time places the onus for greenhouse gas emission reductions on the electricity sector. However, California liquidated much of its industrial base twenty years ago; its core economy is no longer energy intensive. It was once thought that it is easier for us to play games with electric supply and electricity costs, but with the collapse of the "Tech Boom" these games have become a lot less fun.

Michigan seems to be in a different place. In 2008 your Legislature responded to a developing consensus that deregulation is damaging, and that established a forward-looking state strategy for investment in the state's energy infrastructure is an essential component of Michigan's economic revitalization. This included putting a limit on "customer choice."

In a 2007 speech to the Michigan Building and Construction Trades Legislative Conference, a Detroit Edison executive called for an end to de-regulation:

> "...[O]ur hybrid regulatory environment discourages needed investment in the state's energy infrastructure....Michigan must take control of its energy fate and fix the current regulatory structure...It's time for a new model that:
> - Eliminates Michigan's Electric Choice program
> - Encourages renewable energy sources and energy efficiency
> - Adopts a new incentive-based regulatory framework for utilities..."

The apparent convergence of viewpoints among regulators and the major investor-owners of Michigan's electric infrastructure utilities represents a new and promising departure for a state that faces significant challenges in the years ahead. When pursuing this vision, it is imperative that policy makers remain aware that we are talking about *infrastructure*, whose reliability must be maximized and whose costs must remain reasonable and affordable. The goal is investment on just and reasonable terms, not profit maximization through energy trading.

With the remainder of my testimony I will describe broad outlines and some of the details of a regulatory framework that Michigan might pursue as part of its twenty-first century economic revitalization. The elements I will discuss are:

- The role of integrated resource planning (IRP).
- Cost-of-service pricing and the role of benchmark competition by public entities.
- Retail choice and investment in supply.
- Energy conservation and efficiency.
- Protecting the most vulnerable consumers.

1. Integrated Resource Planning as a Guide to Good Investing on Behalf of Consumers

Reducing exposure to wholesale markets through strategies of direct investment in supply by load serving utilities, subject to direct state-level rate regulation (for IOUs) or direct consumer ownership and control (as with municipals and co-ops), is a cornerstone of the approaches that can produce improved outcomes in states responding to deregulation-induced crisis. Equally important is controlling demand through effective investment in energy conservation and efficiency. Investing on the demand side – deploying ratepayers' cash to enable them to reduce their consumption and increase efficiency – is in the interest of both direct beneficiaries of conservation programs (whose bills go down) and non-participants, who avoid escalating costs of supply, including fuel on the margin.

Developing long-term plans that guide investment on both the supply and demand sides of the equation is a necessary prerequisite to effective investment strategy that permits long term moderation and control of retail rates and bills. Planning by load serving entities, that is, utilities, to enable them to meet their long-term obligations to customers is an important element of the California recovery. The planning process in California is public, and is overseen by state

agencies with the authority and competence to acquire and analyze information on local, state and global energy developments.

The objective of a planning process should be to develop a sophisticated statewide approach to managing a portfolio of supply as well as demand-control resources. Such an approach will provide the flexibility to enable Michigan to sustain its economy in the face of significant uncertainty and turmoil in the world energy business. It is a more responsible approach to public policy than simply relying on what the market may offer.

Appeasing wholesale sellers to justify high rates, allowing high retail prices unrelated to actual costs, or masking these high consumer prices by managing gradual rate escalation, is harder to defend. It has been tried and is failing in California and elsewhere. The theory is that higher prices send "signals" to investors that additional supply is necessary and that investment will be rewarded. The California experience suggests that shortages become the justification for high prices, and that maintaining shortage is a strategy that energy suppliers are pursuing to sustain high prices. Planning and investing in order to control all elements of the supply chain for this crucial service is the more responsible approach.

2. Benchmark Competition and the Obligation to Serve – Cost-of-Service Pricing

The utility business is a cash business. It is the cash from retail customers who pay their bills every month that provides the financial underpinnings for *any* investment in energy infrastructure, whether in the form of an equity investment, a debt instrument, a long-term purchase contract or a short-term energy trading account. The only issue from the utility regulator's perspective is how to provide adequate service while minimizing the long-term cash outlays of the committed retail customers. Amortization of direct investments over the life of a long-lived asset has significant advantages from this perspective, as compared with every other alternative, including purchase contracts.

The traditional utility obligation to serve captures the crucial aspect of *mutuality of obligation* between the supplier and end-use consumer. The obligation to serve includes an obligation to plan and an obligation to invest to assure the long-term adequacy of supply to meet

the demand of customers. This long-term perspective is consistent with the capital intensive nature of the infrastructure and the long-lived character of the facilities. The retail competition concept is in its essence short-term. It assumes a degree of instability in the customer base that in practice becomes a deterrent to new investment, and acts as another rationale for sustaining high wholesale prices based on shortage. Revitalizing the obligation to serve, with its long-term, investment oriented perspective, is a sound alternative that moderates prices and assures service.

Utility self-supply facilitates pricing the service at cost. Pricing utility generation at cost, including reasonable capital cost, is particularly important. Legacy power plants were optimally located in the transmission grid, and have been largely depreciated – that is, ratepayers have fully repaid the capital employed for the installed cost and capital additions. Unlike many other states that have deregulated, Michigan utilities still own a solid base on which to expand their generation capacity.

In California there were alternatives whose efficacy was demonstrated by consumer- and community-owned utilities, which for the most part pursued their traditional approaches of supply self-sufficiency. Customers representing the 25% of California load served by consumer-owned utilities – the Los Angeles Department of Water and Power (LADWP), the Sacramento Municipal Utility District (SMUD) and two dozen smaller utilities – were much less drastically affected. The basic reason for these different outcomes was that the consumer-owned entities did not "restructure." That is, they continued to honor their obligation to serve their consumer-owners and retained control over the assets – transmission and generation – that had been built to provide that service over the previous decades. They were not placed in a "short" position and thus not vulnerable. The legal and economic structures of consumer self-supply through entities they own and control have served consumers of all types well in California as benchmark competitors whose success in protecting consumers underlined the failures of the market-oriented policies applied by deregulation to customers of investor-owned utility companies.

Another aspect of benchmark competition by public entities is the transparency of both cost and price that results. Public owners and regulators need to be able to evaluate cost developments, and to base pricing of essential services on those cost developments. In a

complex industry, owners are best positioned to carry out that evaluation. Conversely, a loss of transparency facilitates the pricing inequities and anomalies that characterize the wholesale electricity markets.

This is not inconsistent with maintaining a small role for wholesale markets and trading of capacity and energy on the periphery. Trading around short-term, short-lived diversities in climate, economic characteristics, etc., can optimize the use of generation and transmission resources, if done on a cooperative, mutually supportive basis. The mistake is to assign anything other than a peripheral role to the market.

3. Retail Choice and Generation Investment

In California, utilities supplying retail customers divested much of their generation assets and placed themselves in a net short position as dependent wholesale purchasers of energy and capacity. This was intended to promote the development of retail and wholesale markets characterized by robust competition among sellers, including non-utility, unregulated companies. Such retail sellers are referred to in California as electric service providers – ESPs – and in Michigan as AESs, or alternative energy providers. A similar process occurred in New England and in the Mid-Atlantic States located in the PJM regional transmission organization footprint. Consumers were temporarily shielded from the consequences of deregulation during an initial period of frozen retail rates. Meanwhile, wholesale sellers positioned themselves for a payday, when they would simply mark up the price of output from formerly regulated plants, unrelated to actual production costs. The California Energy Crisis, and the past several years' dramatic rate increases in many deregulated states, was the result.

In Michigan retail choice was instituted, but initially partly collapsed as wholesale prices rose and former "choice" customers returned to utility service. (The same thing happened in California as our Energy Crisis accelerated in 2000-2001.) Now, as wholesale electricity prices have softened with a recession-induced reduction in demand, "choice" customers are flocking back alternative suppliers.

But as we learned in California and as Michigan's 21st Century Electric Energy Plan recognized, AESs are unwilling to make long-term investments in supply projects, either for reliability or for compliance with a state's renewable portfolio standard. It is not consistent with their business model, which is based on short-term wholesale trading strategies on behalf of their customers, or with the concept of "customer choice" that assumes relative ease in changing supplier relationships. In the real world, prudent investment in energy infrastructure to support the economy at the state level must ultimately be driven by local and state economic concerns and commitments, backed by ratepayer cash.

Investment in new generation in California has been made almost entirely by regulated utilities directly or through subsidiaries with long-term supply contracts; by municipal entities with a traditional obligation to serve; and by developers of renewable projects with must-take obligations on the part of utilities resulting from California's renewable portfolio standard legislation. *Ratepayers backstop investments in all these scenarios.* Meanwhile, merchant generators have been canceling projects and exiting the industry.

Consolidation in the utility and energy fuels industries is accelerating a trend toward an approach of strategic under-investing to sustain high prices. (Note, for example, the recently announced natural gas pipeline mega-merger of El Paso Corp. into industry giant Kinder Morgan.) This is not consistent with the interests of buyers/consumers. Responsible public policy at the state level will equip load serving entities (utilities) to be responsive to their customers to control supply and price through direct investment guided by effective long-range planning. This requires a reciprocal commitment from customers to assure the recovery of that investment, that is not consistent with unlimited retail choice.

However, having identified with some specificity the need for baseload generation fueled by coal, the Michigan Energy Plan unaccountably proposed an investor-driven process for new generation with the rate-making sweetener of including financing for construction work in progress (CWIP) in rate base. At the same time, the Plan proposed to shield certain ratepayers from important system costs by preserving the customer choice option of leaving the regulated supplier.

This leaves captive residential and small commercial ratepayers with the worst of all worlds – paying excessive costs in current rates through the CWIP device, while shouldering the burden of extra, unwanted generation capacity. From this perspective any equivocation on restricting retail customer choice along with recommendations on new power plant construction contained in the Plan is quite inexplicable and unjustifiable.

Clearly preferable is restricting retail choice in order to secure forecasted load, and utilizing traditional ratemaking methods of dealing with cost overruns, including reasonableness reviews and/or deferred recognition of excessive costs. If the deterrent effect of traditional methods is given up through the CWIP device, the attendant reduction in risk should be accompanied by a reduction in authorized return. *The point is to recognize reciprocal obligations between supplier and user*, while eliminating speculative profiteering inherent in unregulated energy markets.

4. Conservation and Efficiency

The Michigan Energy Plan proposed a comprehensive state-wide energy efficiency program, the Michigan Energy Efficiency Program (MEEP), funded by an electric surcharge and administered by an independent third party that is not a retail service provider. This is a powerful idea that clearly complements the supply-side elements of the integrated resource plan. This proposal is supplemented by two additional important measures: improved energy efficiency standards for buildings, and state-level interventions to improve appliance efficiency. All three of these measures should be pursued as proposed.

However, the MEEP should be expanded to explicitly include home weatherization programs funded in part through a natural gas surcharge that supplements federal Low Income Home Energy Assistance Program (LIHEAP) funds and leverages other state and federal housing assistance funds, as well as the private sector funds identified in the Michigan Energy Plan. Home weatherization that reduces energy usage for both heating and cooling without

jeopardizing occupants' health and comfort is a much more effective and humane approach than price gouging to prevent usage, particularly for Michigan's low income and senior residents.

Smart meters and real-time pricing for residential and small commercial customers, on the other hand, grow utility rate base without increasing functionality. Without giving any explanation or justification, the Plan proposes aligning retail rates with hourly wholesale prices as an improvement in "demand response." As discussed below, wholesale prices are an unreliable tool for guiding either investment or cost recovery, let alone pricing for essential services.

Rather than growing rate base with smart meters, utilities should be permitted and encouraged to invest in energy reducing appliances and equipment to be installed on customer premises, with capital recovery through depreciation, with return accomplished in the same manner as other capital items. Air conditioner cycling programs coupled with installation of more efficient air conditioners is an example of one such programmatic approach.

We ought to acknowledge that energy is used when it is needed most. The increase in usage on a hot summer day ought not to be an occasion for price gouging or punishing the most vulnerable customers; rather, it should be planned for, as efficiently as possible, with cost recognition and cost recovery accomplished in a manner fair to utilities and beneficial for end-users. We should dispel the economic mythology used to justify peak pricing. The "spike" for peak hour costs results from an *accounting* approach that recognizes and recovers costs of peaking plants over the few hours of actual operation, rather than accounting for them as reliability "insurance" or physical hedges to be recovered from all ratepayers over the total number of annual hours. The latter approach is as reasonable from both policy and economic perspectives as the former.

5. Protecting the Most Vulnerable Consumers

California sheltered our most vulnerable populations – senior citizens and low-income households – from the worst effects of our Energy Crisis, using several devices. There may be lessons for Michigan policy-makers in this aspect of California's response to crisis.

Pursuant to statute, California's residential electric and gas rates are inverted (that is, per unit prices increase as usage increases). The objective is to promote conservation and preserve affordability. The basic rate structure provides a minimum level of usage – 55 % of average usage in the customer's geographic area – priced at a discount from the residential average rate. In response to the Energy Crisis the Legislature exempted usage up to 130 % of the baseline allowance – about 70 % of average residential usage – from rate increases driven by the Energy Crisis for all residential customers.

The Legislature and the Public Utilities Commission (CPUC) also expanded statutory low-income discount programs in several ways. The Legislature exempted eligible CARE customers from Energy Crisis driven rate increases; the CPUC increased CARE eligibility standards to 175 % of the federal poverty level and expanded outreach programs to enroll a larger proportion of eligible customers. Currently, about 75 % of eligible Californians, approximately 2.3 million households, receive discounts of 20 % on their monthly electric and gas bills.

The Legislature expanded energy efficiency and conservation programs targeted to low-income households and established a Low Income Oversight Board made up of utility and community representatives to advise the CPUC on the design and implementation of these programs. Home weatherization programs were expanded and programs to improve appliance efficiency and safety were implemented.

6. Elements of Wholesale Electric Price Formation and the Dangers of FERC

Achieving a comprehensive understanding of the forces driving wholesale prices is another important element of any response to the deregulation-induced crisis. In California wholesale rate spikes were driven both by manipulation of electric supply availability and price

and by manipulation of fuel availability and price – particularly natural gas fuels. Gas prices drove formula rates for wholesale transactions, even though the majority of California generation is not gas-fired. Price formation was opaque, and driven by bidding strategies unrelated to costs (the Enron manipulations and "hockey-stick" bidding of unit output), particularly for divested power plants whose operating characteristics and cost structures were known.

Generator profits soared on the strength of wholesale price escalation. The FERC was absent and/or obstructionist, although presented with complaints and evidence of illegal, unjust and unreasonable rates and practices in both gas and electric wholesale markets early in the Crisis. FERC's failure to provide timely relief trapped the utilities and severely damaged customers and the California economy.

This experience should raise serious doubt about any proposals to reflect wholesale prices in retail rates. The Michigan Energy Plan specifically recommended experiments with what it calls "passive demand response," as a way of establishing direct correlation between wholesale prices and retail rates.[1] But wholesale generation price formation in the MISO and in Michigan remains opaque. Aggressive efforts to discover how prices are being formed, coupled with actions for enforcement of the just and reasonable requirements of the Federal Power Act, should *precede* any decision to reflect wholesale price escalations in retail rates.

Advocating for more responsible action by the FERC as the regulator of wholesale transactions in interstate commerce – focusing on greater transparency of seller costs, mitigating seller market power and controlling seller positions in the various markets where energy commodities are traded, to prevent undue influence, self-dealing, linkage and leverage – is an important element of addressing the challenges faced by Michigan. Skepticism about any conventional wisdom that justifies escalating wholesale prices and rigorous analysis of all purported justifications is both necessary and proper.

The Federal Power Act provides both a venue at FERC, and authority for state regulators to investigate. Heightened dependence on generation assets outside of state regulatory control and the wholesale pricing schemes under which supply is provided to Michigan ratepayers at

[12] Michigan Energy Plan, pages 38-39.

elevated mark-ups should be examined from all angles before concluding that elevated prices should be reflected in retail rates.

In addition to attempting to use the FERC venue, California created a special state legislative investigating committee that pursued the darker corners of price formation. The notorious Enron memos were disclosed as a result of California State Senate investigations, as was the role of round-trip trading and other manipulations of price disclosure in natural gas markets.

However, contesting wholesale pricing at FERC under the Federal Power Act's "just and reasonable" standard is not a permanent solution. As experience in California and other states suggest, the most substantial relief is afforded only by a return to state cost-of-service regulation for a substantial portion of the electric supply resource, thus limiting consumer exposure to wholesale supplies and prices.

Conclusion

Michigan is facing a challenge caused by unstable and unpredictable prices in wholesale electric markets, with lagging investment in new generation, the inevitable result of the state's deregulation project. Rates for electric service in the Midwest are poised to increase dramatically in the next few years, especially as the economy improves as it eventually must. However, there are other approaches which are rooted in a perspective that the public interest is best served when end-users of the energy infrastructure, who pay the bills and support the investments, are well served. Specifically:

- Re-invigorate the utility obligation to serve, including:
  * Instituting long range planning;
  * Making direct investments at regulated rates in both supply and conservation;
  * Moving away from primary emphasis on short-term arrangements and transactions (retail choice and the wholesale arrangements that provision it).

- Empower load serving entities to serve their customers using a portfolio of measures, relying on direct investment by state-regulated utilities carrying out the state's long-range energy strategy, rather than on FERC-jurisdictional wholesale markets or short-term arrangements.
- Make transparent the forces driving up wholesale prices, and control them before deciding to reflect them in retail rates.
- Eliminate market power and unwind transactions found to be not in the public interest.
- Protect the most vulnerable consumers during the transition to a strategic investment plan.

Remaining focused on the well-being of the public – the residential, commercial, agricultural and industrial end-users who rely on a reliable, low-cost energy infrastructure – will serve the State of Michigan well in the years ahead. Thank you for this opportunity to address you.

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